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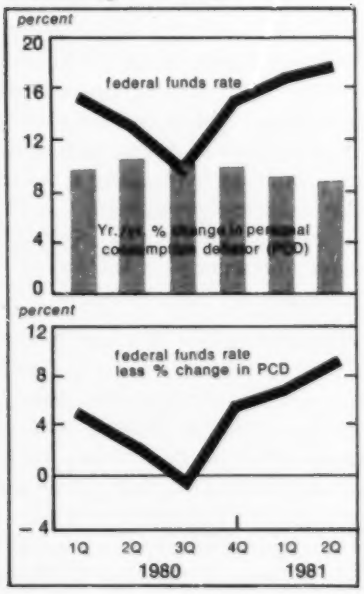
High Interest Rates Dimming U.S. Outlook

Just one year after the end of the last U.S. recession there is mounting concern about the likelihood of another downturn, possibly of longer duration. The pace of spending continues to decline in such interest-sensitive sectors as autos, housing, and capital investment. Some involuntary inventory imbalances may also be developing. Uncertainty about the economy's health is heightened by the wide margin by which interest rates have exceeded inflation. In the second quarter of 1981, the federal funds rate was more than nine percentage points above the trend inflation rate, compared with an average of three percentage points in 1980. Other interest rates show similar patterns.

In view of the duration of unusually high real interest rates, there is great anticipation about Federal Reserve Chairman Volcker's semiannual report to Congress to be delivered this week. Volcker will outline U.S. monetary policy objectives for the balance of 1981 and for 1982. The Federal Reserve's money growth targets are not expected to be high enough to sustain much "real" growth over an extended period—at least so long as the underlying 9% inflation rate persists. Indeed, the current policy response to the recent below-target performance of M1-B may be a lower target. Furthermore, there may now be added policy emphasis on the broader M2, which has been above target. Thus, during coming weeks the Federal Reserve seems unlikely to provide grounds on which to base expectations that an appreciable decline of interest rates is imminent.

Real interest rates high in U.S.



The persistence of relatively high interest rates is a major element prompting new doubts about the "consensus" economic forecast of a flat GNP in the third quarter and a relatively strong upturn in the fourth quarter. To be sure, an important basis for the projected fourth-quarter growth has been the tax cut expected to take effect in October. But timely completion of tax legislation is by no means assured. Moreover, even with the tax cut, final demand in the economy over the next few months—especially in the durables and investment sectors—may be sufficiently weak that inventory corrections later in the year will delay a strengthening of employment and production. Furthermore, for the near term the best inflation news is probably already at hand. New advances of food and energy prices, which appear likely by the fall, would diminish consumer spending power. In sum, the remarkable resilience exhibited by the U.S. economy in the past is again being put to the test. Continued restrictiveness of monetary policy may well put off any material U.S. economic recovery to 1982.

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Canadian monetary policy aimed at slowing money growth to dampen inflation.

Canada's central bank has succeeded in slowing the rate of money supply (M1) growth to an annual rate of 2.5% in June after having exceeded its targets in the two months previous. (The annualized rate of money growth was 9.6% in April and 7.2% in May.) The target range for M1 growth is currently 4%-8%, lowered from the previous 5%-9% range last February in a stepped-up effort to dampen inflation, which has been running at over 12%. The constraints on monetary growth have helped push Canadian interest rates very near to U.S. levels, with the central bank's floating rate and Canadian prime in the 20% vicinity. The authorities intend to maintain their stance as long as inflation expectations—and U.S. interest rates—remain high.

Irish economy beset by structural imbalances; curative policies nowhere in sight.

The Irish economy continues to exhibit serious structural imbalances. Much of the recent growth has come from the export-oriented industries, which now find their markets declining in view of the European recession. As a result, economic growth is slowing, and the balance of payments is weakening. At the same time, the government is running a huge budget deficit (some 9% of GNP), which results less from falling revenues in the wake of domestic recession than from mushrooming expenditure. In addition, the underlying rate of inflation is accelerating, and, following some tax increases on gasoline, alcohol, and tobacco, the consumer price index will probably end the year some 20% above its level at yearend 1980. Tough, but unpopular, government policies could set the economy on a firm recovery course. Yet given the new prime minister's fragile majority based on a coalition with the small labor party, his government is not likely to launch any major new initiatives. Consequently, there is little hope for improvement in the near term.

Israeli economic growth brisk, but structural problems need addressing.

Signs of economic growth in Israel in the first half of 1981 mask a disturbing economic picture. Inflation continues unchecked at over 130%, and the trade deficit—although having narrowed—is still running at 25% of GDP. Economic performance in the first half reflected pre-election measures to boost growth, bolster government revenues, and cut cost pressures by slashing indirect taxes. The net result was some pick-up in industrial output, but no abatement of inflation. Real GDP growth may approach 3% this year, but consumer prices are likely to rise by an average of nearly 125%. The current account is expected to deteriorate in the second half, widening the 1981 deficit to a forecast $1.5 billion from $1 billion in 1980. The fundamental long-term economic issue to be addressed is reconciling demands for a rising standard of living with growing external debt and a large defense burden. The adjustment to higher oil prices and the resultant loss of real income requires reduced domestic absorption of goods and services relative to total output. To date, this has been postponed by running a current-account deficit. The challenge to be addressed is reducing government spending, shifting the burden of adjustment from the corporate to the personal sector. But since a reduction in government spending can only be secured at the expense of social and industrial programs, any such initiatives are not likely to be significant.

Korea's new five-year plan entails revised economic strategy.

The Korean government has unveiled a preliminary outline of a new five-year (1982-86) economic and social development plan, whose substance suggests a major reshaping of economic strategy. The plan concedes that previous policies—particularly preferential loans to heavy industry—distorted Korea's industrial structure and led to higher inflation and increased disparities among income groups. The new plan, however, envisages more even-handed government encouragement of industrial investment. Furthermore, domestic producers will be exposed to foreign competition by means of import liberalization, and price stabilization will be sought by the gradual elimination of subsidies to farmers and by reducing preferential loans to industry. In the financial sector, commercial banks will be turned over to private ownership, and the capital market gradually internationalized. All in all, the plan projects, tentatively, annual average real growth of 11.9% for exports and 7.5% for GNP over the plan period.

Continued domestic economic sluggishness delaying Japanese economic recovery.

Although the Japanese economy appears to have bottomed out, the continued weakness of domestic demand is resulting in a somewhat slower-than-expected recovery. Inflation-adjusted gross national product rose at a respectable 4.5% seasonally adjusted annual rate in the first quarter of 1981, but a surprisingly strong export showing accounted for most of the increase. In real terms, private consumer spending rose at only a 1.2% annual rate, and private plant and equipment investment increased at an annual rate of less than 1%. This weakness in domestic demand is prolonging the inventory adjustment in some industries, such as steel. As a result, industrial production continues to vacillate, declining by a seasonally adjusted 1.6% in May after rising a scant 0.3% in April. However, with the 7.7% average wage increase resulting from this spring's labor negotiations and the moderation of consumer price inflation to a little over 5%, consumer spending is likely to pick up strongly. This is expected to spur a relatively sharp recovery in the domestic economy in the second half of 1981.

Brazil's economic slowdown brings relief to inflation and the trade deficit.

Brazil's economy has slowed considerably in response to policies aimed at curbing inflation and narrowing a balance-of-payments deficit. Industrial production in the first five months of 1981 showed no gain over 1980, and output is likely to continue falling over the next two to three months. The pace of inflation, however, has slowed. The general price index's growth rate declined from 7.5% in the first quarter to 5.4% in the second. Also, the trade deficit in the first half was pared by $1.75 billion to $282 million, helped largely by lower oil imports. These improvements have aided Brazil's international borrowing campaign. In the first half of 1981, nearly $10 billion in new loans was raised, which lifted reserves in May to $6.4 billion from $6.2 billion in April.

Malta's strong economic showing undisturbed by world recession and high oil prices.

The Maltese economy has performed well recently, further consolidating its dynamic performance during the 1970s, despite world recession and rising oil prices. Tourism, once again, was the main source of growth in 1980, with arrivals up 12% from 1979. Malta's external position has remained strong. The current account posted a record surplus of $125 million last year, despite the closure of U.K. military facilities; it has remained in the black through both periods of major oil price increase. Malta's external reserves, estimated at $1 billion, are sufficient to cover 15 months of imports. The only causes of concern are the recent reversal of the downward trend in unemployment and the expectation that tourism will suffer adversely because of the U.K. recession. Meanwhile, the prime minister has launched a new five-year development plan that calls for 7% average real economic growth through 1985. Priority is to be given to stimulating foreign-exchange revenues from the already successful manufacturing sector and ship repair facilities. The plan envisages the creation of 10,000 new jobs, which would return the island to full employment.

Kuwait's 1980 current account surplus was a record-breaker.

Kuwait recorded its largest current-account surplus ever last year—$15.8 billion, according to official sources, up from $14.2 billion in 1979. Oil export earnings rose 10% in 1980, despite a 37% drop in output to an average 1.39 million barrels daily, owing to a 61% jump in the official export price to $29.84 per barrel and to premiums of up to $5.50 per barrel for a large proportion of exports. The result was gross oil revenues totaling $19.2 billion last year. Imports also rose sharply in 1980, climbing by some 38% to $6.9 billion because of a more expansionary budget. The resulting trade surplus of $13.8 billion was only marginally higher than in 1979. But net service exports jumped 63% to $3.6 billion—spurred mainly by $6 billion in income from foreign assets valued at $62 billion at end-1980. This year, the current-account surplus is projected to narrow to $10-$11 billion, despite slower import growth, as oil revenues will be down significantly. The current worldwide glut of petroleum has prompted a further cut in Kuwait's output ceiling to 1.25 million barrels daily last April. Revenue per barrel of oil exported will also be lower in 1981, with official prices likely to remain stable and premiums virtually gone.

Disputing Money Fund Curbs

In the face of mounting pressure on depository institutions, Federal Reserve Chairman Paul Volcker has recently presented a plan to impose reserve requirements on money market mutual funds (MMMFs) providing checking-account services. If this proposal is enacted, the funds, like commercial banks and savings institutions, will be required to set aside a portion of their deposits in non-interest-bearing reserves. Mr. Volcker maintains that this step would facilitate the Federal Reserve's control of the money supply and improve the competitive position of depository institutions. Evidence seems to suggest, however, that imposing reserve requirements on money funds would fail to achieve these goals.

The money funds have prospered in an environment of unusually high and volatile interest rates. Depository institutions have been unable to meet investor demand for high short-term yields, however, owing to two regulatory curbs: the restrictive ceilings on interest rates payable to these intermediaries on deposits, and reserve requirements, which impose an effective tax on the use of depository institution funds.

MMMFs represent the competitive market's response to the inability of existing institutions to satisfy investor demand. But Volcker argues that the money funds have also had undesirable consequences for monetary control and competitive equity. Since many money funds offer easy redeemability by allowing check writing on deposited funds, it is possible that fund shares are being used as transactions balances. If such utilization is widespread, it blurs existing definitions of money, and, according to Volcker, weakens the Fed's ability to implement monetary policy. Moreover, the MMMFs have diverted funds away from banks and thrifts, which, hampered by regulation, have been unable to compete on an equal footing for investors' savings. Chairman Volcker's plan addresses both of these problems. By requiring the funds to place reserves with the Fed on accounts accessible by checks, a potentially unregulated medium of exchange would be brought under the Fed's control. Moreover, the holding of non-interest-bearing reserves would reduce the MMMFs' profitability and thereby remove a source of their competitive advantage over depository institutions.

The issue of monetary control calls for empirical support, since the existence of check-writing capability is not by itself evidence that investors utilize MMMF deposits for transactions purposes. What would constitute such evidence would be an increase in the turnover of MMMF assets corresponding to the increase in their asset bases over time. The ratio of total redemptions to total net assets over the last 10 quarters, however, exhibits no particular trend and has averaged a little more than 2.75 per year. Indeed, the average for the first half of 1981 is actually lower than the 2½-year average and is not significantly different from the turnover ratio on savings deposits.

Although this evidence fails to support the hypothesis that investors are using MMMFs as checking accounts, Volcker argues that further innovations by the funds, such as the availability of margin accounts and credit cards for customers, could increase the turnover rate. These services, however, are already offered by many MMMFs, and there is no evidence that they have done so.

Finally, Volcker suggests that aggregate turnover ratios may be masking a significant amount of transactions among subcategories of investors, citing the possibility of the writing of large checks on MMMF accounts to pay several small bills. But the motivation for investors to behave in this way, given high levels of interest rates, is unclear. In any event, since disaggregated turnover data is unavailable, this hypothesis remains unsupported.

The other justification given for imposing reserve requirements on the money funds is to "equalize competitive conditions" so that depository institutions can have equal access to savings. But regulating to encourage competition is a dubious approach. Furthermore, if the MMMFs were subjected to 12% transactions reserves, for example, the yield they could offer investors would decline by a bit more than two percentage points. Since the current yield spread between MMMF shares and comparably liquid accounts of depository institutions is considerably greater, the change could hardly benefit banks and thrifts. Moreover, those individual investors not having access to direct market instruments would be harmed, and the resulting decline in the yields they receive could adversely affect the level of savings in the economy.

On the other hand, there is reason to believe that the plan would not even effectively constrain the MMMFs. Since reserves would only be required on accounts with check-writing privileges, investors could avoid the reserve tax by maintaining minimum balances in reservable accounts and transferring funds from their unregulated accounts as needed.

But in a larger sense, the Volcker proposal is misdirected because it fails to recognize that the existing regulations have created the disparity between the funds and the depository institutions. As long as reserve requirements affect the yields that intermediaries can offer, the incentive to create new institutions or services to circumvent the regulations will persist. The more logical approach is thus to remove the incentive entirely by eliminating this reserve burden, allowing the Federal Reserve to pay interest on reserve balances. This would place depository institutions on an equal competitive footing and end the need for continuing regulation of new types of financial institutions and vehicles that evolve to meet investor demand for high-yielding liquid assets. The Depository Institution Deregulation Committee has moved to phase interest-rate ceilings out. The next step would be to ease the reserve-requirement burden.

Carl Alan Batlin

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes							
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	central bank rate July 15, 1981	exchange rate in U.S. dollars July 15, 1981	current monetary conditions	
Austria	Economy showing signs of bottoming out, but no sharp upturn foreseen.	Oct.	+ 3%	75.8	+ 3.6%	May	4,371	+ 21%	2.4	0	Devaluation of real exchange rate improves export prospects.	Apr.	+ 7%	Mar.	+11%	6.75%	.0587	Interest rates await fall in German rates.	Austria
Belgium	Economy weak, with industrial investment squeezed by overvalued currency and high interest rates.	Apr.	— 7%	118.9	+ 1.5%	May	6,876	+ 7%	1.2	0	Current-account gap expected to widen from 1980's $5.2 billion.	June	+ 7%	Dec.	+ 3%	13.00%	.0252	Rates vary inversely with franc pressures, but remain high.	Belgium
Britain	Recession now nearing its end, but recovery still some way off.	May	— 8%	518.7	— 1.2%	May	18,198	— 18%	2.0	512	All signs point to continuing external-accounts surplus.	May	+ 12%	Mar.	+ 8%	12.00%	1.8860	Recent pound weakness puts upward pressure on rates.	Britain
Denmark	Economic output continues to fall gradually.	Mar.	+ 4%	67.1	— 0.8%	May	2,601	+ 16%	1.7	0	High interest payments on foreign debt offsetting trade balance upturn.	Apr.	+ 12%	Dec.	+10%	11.00%	.1325	EMS membership keeps rates high.	Denmark
Finland	Economy slowing down gradually, but 1981 real growth still estimated at 2.5%.	Mar.	+ 1%	51.0	+ 6.0%	May	1,570	— 14%	1.3	78	Jan.-May current account posts fmk. 382-million surplus vs. deficit year ago.	Apr.	+ 12%	Nov.	+ 5%	9.25%	.2218	Rising inflationary pressures force tough monetary stance.	Finland
France	Business confidence remains low despite plans to reflate economy.	Apr.	— 8%	651.1	+ 1.2%	May	29,493	+ 15%	2.7	0	Trade gap may widen later in year as consumer spending picks up.	May	+ 13%	Feb.	+12%	9.50%	.1749	More stable exchange rate permits interest-rate easing.	France
Germany	Domestic demand remains flat; 1981 budget more expansionary than originally planned.	May	0	827.7	+ 1.8%	May	50,122	+ 4%	3.4	0	Export orders continue to surge in response to weak DM.	June	+ 6%	Apr.	+ 2%	7.50%	.4148	Interest rates await developments in U.S. credit markets.	Germany
Ireland	Real economic growth in 1981 not likely to exceed 1%.	Feb.	— 1%	17.6	+ 1.9%	May	2,304	+ 10%	2.5	0	Payments deficit expected to reach $619 million this year, 13% of GNP.	Feb.	+ 21%	May	+15%	14.40%	1.5000	Huge budget gap and weak currency keep rates high.	Ireland
Italy	Leading indicators point to renewed economic weakness, but inflation stays over 20%.	May	— 3%	394.9	+ 4.0%	May	15,999	— 28%	1.9	0	Trade deficit widening continues, with exports still weak.	June	+ 21%	Feb.	+15%	19.00%	.00083	Six-month import-deposit scheme introduced.	Italy
Netherlands	Domestic demand remains flat as inflation slows; no immediate prospect of reflation.	May	— 5%	160.8	+ 1.2%	May	9,315	— 9%	1.5	0	Current account posts IQ surplus of 1.4 billion guilders vs. deficit year ago.	May	+ 7%	Mar.	+ 4%	9.00%	.3738	Rates ease as guilder remains strong in EMS.	Netherlands
Norway	Oil output volume falling; GDP will likely show small decline this year.	Feb.	— 4%	56.7	+ 3.6%	May	6,386	+ 30%	4.5	0	Oil price cut will narrow IQ's current-account surplus of kr. 3.07 billion.	May	+ 14%	Jan.	+12%	9.00%	.1652	Rates high in face of 15% inflation rate.	Norway
Portugal	Official economic growth estimate for 1981 reduced to 2.9% from 5%.	Sept.	0	24.1	+ 3.9%	Apr.	476	— 16%	0.6	85	Bad weather may worsen payments balance despite good tourism prospects.	Apr.	+ 17%	Dec.	+13%	18.00%	.0158	Government planning tighter control of bank lending.	Portugal
Spain	Economy remains in recession with no sign of recovery.	Dec.	+ 5%	208.5	+ 0.5%	Apr.	10,520	— 9%	3.7	211	Weak peseta unlikely to improve poor payments-balance prospects.	Mar.	+ 16%	Mar.	+11%	8.00%	.010415	Domestic interest rates firm.	Spain
Sweden	All demand components except public consumption likely to fall in 1981, yielding 1% GDP decline.	Mar.	— 3%	124.3	+ 2.3%	May	4,131	+ 25%	1.7	0	Current-account deficit narrowing gradually; IQ gap was kr. 3.14 billion.	May	+ 15%	n. a.	—	12.00%	.1952	Domestic monetary policy remains restrictive.	Sweden
Switzerland	Slackening pace of economic activity continues past mid-year.	Dec.	+ 1%	99.8	+ 2.4%	May	10.436	— 13%	4.0	0	Reduced import volume narrows Jan.-May trade gap to $1.5 billion.	June	+ 6%	Mar.	— 2%	5.00%	.4835	No easing in central bank's tight money stance.	Switzerland
Turkey	Pick-up in economic activity fueled by greater import availability and reduced inflation.	n. a.	—	53.5	— 2.2%	Jan.	1,305	+121%	2.4	1,163	Favorable export showing in Jan.-Apr., but trade gap stays large.	Apr.	+ 37%	n. a.	—	—	.009955	Lira exchange rate now set on a daily basis.	Turkey
Canada	Industry output growing at 4% rate, led by manufacturing and retail sales.	May	0	246.5	+ 0.1%	May	2,322	— 28%	0.4	0	Trade surplus running at $7.2 billion annual rate.	May	+ 12%	June	+ 3%	19.09%	.8305	June M1 growth rate slowed to 2.5%.	Canada
United States	Economy on a flat-growth course, with tight money policy constraining spending.	June	+ 8%	2,626.5	— 0.1%	May	18,241	+ 70%	0.8	0	Lower oil imports offsetting export slackening.	May	+ 10%	June	+ 9%	14.00%	—	Money growth weak; business credit demands strong.	United States

World Interest Rates

market rates of July 15, 1981; bond yields as of July 10, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	19.09	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	19.00 July 16	19.00	12.00	11.35	18.75	12.00	20.00	10.625	3.00	7.4375
Treasury Bills 91-day, Middle Rates	14.49 discount basis	18.80	12.9375	16.25	n. a.	n. a.	19.501 350-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	16.00 finance paper discount basis	19.10 finance paper 15% tax w/h	12.09	12.90 Certified	17.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.70	19.10 15% tax w/h	13.00	12.90 Certified	not traded	9.90	22.55	no market	10.00	no market
Government Bonds Long-term, new and old issues, average yield	13.54	16.25	14.77	10.465 20% tax w/h	16.575	10.47	20.40	11.53	5.53	8.14
Industrial Bonds prime, long-term, new and old issues, average yield	14.45 Aa Industrials	17.00	15.83	15.065	17.85	11.30	20.70	12.94	6.1125	7.23
Bank Short-Term Rate to Best Borrowers (prime rate)	20.50	20.00	13.00	18.00	19.60	14.50	22.50 ⅛ quar'ly fee on outstdng.	13.50	9.50	6.75
Bank Time Deposits 3-month	16.75 Cert. of Dep.	18.90	13.375	16.00	17.50	12.75	10.75	12.25 large deposits	9.50 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.00	no market	13.625	no market	23.50	12.4375	no market	12.25	9.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8305	1.8860	.0252	.1749	.4148	.00083	.3738	.4835	.004341
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.00 *D*	4.50 *P*	0.50 *D*	5.40 *D*	5.60 *P*	11.00 *D*	5.90 *P*	8.20 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
July 16

7-day	18.25
1-month	18.312
3-month	18.187
6-month	17.875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.77
U.S.-Canada Treasury Bills	−2.22
U.S.-Canada Finance Co. Paper	−1.838
Eurodollars-U.K. Local Auth. Deposits	−0.1875

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.50
Over 7 yrs.	15.25
DM Bonds	
7 yrs. and under	11.375
Over 7 yrs.	10.50

Gold Price
London afternoon fixing
412.24
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	9.8 (May)	12.3 (May)	11.7 (May)	12.7 (May)	5.5 (June)	20.6 (June)	6.4 (June)	5.4 (May)
Industrial production*	7.9 (June)	0.3 (May)	−8.0 (May)	−8.1 (Apr.)	0 (May)	−2.7 (May)	1.0 (Dec.)	−0.2 (May)
Trade balance† *(billions of local currency units)*	−$3.40 (May)	C$0.37 (May)	£0.31 (Feb.)	−FF3.34 (May)	DM1.57 (May)	−Lit.2,870 (May)	−SF0.72 (June)	¥190 (May)
Money supply (M1)*	8.5 (June)	3.0 (June)	7.6 (Mar.)	11.5 (Feb.)	1.5 (Apr.)	14.9 (Feb.)	−1.9 (Mar.)	−4.2 (Mar.)
Velocity of money (M1)*	12.9 (Mar.)	−0.14 (Dec.)	9.8 (Dec.)	n. a.	0.7 (Mar.)	6.7 (Dec.)	n. a.	10.5 (Dec.)
Reserves minus gold *($ million, change from previous month)*	−300 (May)	53 (May)	−2,073 (May)	−554 (May)	513 (May)	−1,603 (May)	−768 (May)	357 (May)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Assessing Eurocurrency Market Trends

The ability and efficiency with which the Eurocurrency markets adapt to changing financial conditions can be just as impressive in times of seemingly little stress as during times of crisis. In 1980, for example, the world oil market was relatively calm, particularly when compared with the sharp price rises that characterized the market in 1979, imposing lesser demands on the Eurocurrency markets. Indeed, by the end of 1980 the world was entering a sustained period of declining oil prices, easing considerably the current-account stresses of many countries. Nonetheless, there were many forces of change in international financial markets over the course of 1980, which the Euromarkets accommodated with efficiency and ease.

One of the major factors influencing world capital markets in 1980 was the volatile behavior of U.S. interest rates, characterized by not one, but two, major rate cycles. These rate cycles were the result of the Federal Reserve's switch to money-supply control via non-borrowed-reserve targeting and the Fed's difficulty in accomplishing its new tasks smoothly. The result was a period of relatively "tight" monetary conditions through the first quarter of 1980, followed by two quarters of relatively "loose" policy, with the year closing on a very "tight" note.

Despite these major fluctuations in U.S. interest rates and the fast growth in Euromarket lending that took place last year, "the rapid growth in the volume of international bank credit occurred without a general tightening of market conditions", according to the Bank for International Settlements (BIS). While interest rates in the United States and the dollar sector of the Eurocurrency market were certainly high by historical standards, contends the BIS, credit was plentiful at these rates and, significantly, Euroloan spreads were relatively narrow. Many borrowers in the Eurocurrency markets, however, took a different view. They saw high interest rates as an indication of tight market conditions.

This confusion in interpretation rests on more than conflicting definitions of what constitutes "tight" monetary conditions. Some analysts consider the existence of relatively high real interest rates as a measure of tightness. The BIS definition of tightness, however, is focused on the availability of credit at any price. In either case, a key to understanding how the Euromarkets react to high and variable dollar interest rates requires an understanding of the function of the two key prices that equilibrate the supply of and demand for credit in the Eurocurrency market. The two prices are the interest-rate level (e.g., London Interbank Offer Rate) and the spread over the standard interest rate (LIBOR or some other base rate).

Interest-rate levels for the various currencies in the Euromarkets are essentially determined in the respective domestic financial markets, with some feedback from worldwide markets. Dollar interest rates, for example, are determined in U.S. markets by the interaction of such influences as Federal Reserve policy and the market's inflation expectations. Whether resulting rate levels are high does not say anything about the availability of funds in the Euromarkets. The imposition of credit controls in the United States in the spring of 1980 caused "tight" monetary conditions in the classic sense, as some market participants (such as credit-card holders) were denied sources of credit even though they could and would have paid a higher price. But such tightness failed to carry over to the Euromarkets because such rationing of credit requires regulations that cannot be imposed on the Euromarkets.

The spread over the standard interest rate on Euroloans also has nothing to do with whether market conditions are tight or loose. It is determined by the interaction of competitive forces and reflects bank costs (interest and general operating expenses), borrower risk, and anticipated profits. Competitive conditions guarantee that the profit component will reflect only a reasonable return on capital, since other banks would be willing to accept lower spreads. Spreads, then, are independent of monetary conditions in the home currency country and are not a reflection of monetary policy. In 1980, the dominant factor affecting spreads was the risk assessment of major borrowers. In the past, and particularly in 1974 and in 1979, OPEC price hikes were the dominant cause of changes in risk assessments in the market. Oil price increases triggered severe current-account financing problems for many countries, and the subsequent ability of some countries to repay their commitments changed. In 1980, however, these considerations steadily diminished in importance. As a result, spreads were relatively narrow.

The actual impact of high and variable U.S. interest rates on the Eurocurrency market last year was limited to timing considerations on the part of borrowers. In the first quarter, there was a generalized sense that interest rates would decline later in the year and that borrowing should be postponed if at all possible. But during the second rate cycle, this expectation was less widely held and most borrowers tended to proceed with borrowings. Generally, Euromarket borrowing by countries with current-account financing needs is not particularly interest-rate sensi-

Assessing Eurocurrency Market Trends *(continued from page 7)*

tive. This is because borrowers have few alternatives. The high and variable U.S. rates last year, for example, increased real returns in all dollar bond markets, and Eurobond markets are not a viable alternative source of funds for many developing countries. Thus, many countries with external-account financing requirements are tied to the Euromarkets for funding.

Although the world oil market was calm in 1980, imposing less demands on the Euromarket for current-account deficit financings, the markets witnessed shifts in OPEC behavior that tested their ability to reallocate funds among Eurobanks and to obtain new sources of funds. At the start of 1980, the OPEC countries were a principal source of new funds for the Eurocurrency market. By the end of the year, however, they were only a negligible source of new funds. This occurred for two main reasons: the OPEC members appeared to be favoring longer-term non-bank investments; and they were forced to increase their borrowings late in the year as their oil revenue growth came under increasing pressure. Furthermore, in the wake of the Iranian crisis, OPEC countries have tended to allocate new deposits to non-U.S. banks to a much greater degree than previously.

The reduced role of OPEC as a source of new funds for the Eurocurrency market occurred with little notice, owing largely to the efficiency of international arbitrage between dollar financial markets. Eurobanking depends heavily on the liquidity of the interbank market, and the ultimate source of funds is not important. The only possible impact is through changes in spreads among certain assets, as one set of investors may prefer one asset over another. Hence, the spread between Eurodollar time deposits and U.S. Treasury bills or U.S. commercial paper could be affected.

The second OPEC shift, that of an increasing preference for non-U.S. banks for new deposit placing, also had no effect on the market. Indeed, interbank markets were established for just this sort of accommodation. There were, however, some subtle impacts on banks. To the extent that a flow of new OPEC funds at interest rates a shade below interbank rates had been anticipated in the profit calculus of setting fees and spreads on lending, some U.S. banks may have suffered some weakening in their average cost positions—but not in their marginal cost positions.

In the absence of an OPEC price shock, Eurocurrency market trends are likely to continue responding to world growth and inflation patterns. The growth of the market (net size) may slow to less than 20% in 1981, compared with 22% growth last year, however, because of a reduction in U.S. and, thus, dollar inflation rates. (The Eurocurrency markets are measured in nominal terms so that any slowing of inflation is likely to be reflected in growth measures, real volume being held constant.) Inflation-adjusted lending is likely to grow by 8%-10% this year and in 1982, reflecting a rebound in world economic growth in late 1981 and in 1982.

Aside from growth trends, 1981 and 1982 will see increased experimentation with non-standard loan pricing and currency options. Some borrowers have obtained loans with spreads over U.S. bank prime rather than LIBOR. And these loans have captured the interest of U.S. regional banks. Also, more Special Drawing Right (SDR) loans are coming to the market. The new five-currency SDR basket is easily hedged for banks covering dollar funding risks, while the borrower may remain unhedged and take advantage of the interest-rate and exchange-rate diversification offered by SDR loans. *Bluford H. Putnam*

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	**IQ/80**	**IIQ/80**	**IIIQ/80**	**IVQ/80**	**1979**	**1980**	**1981**
Gross Size (Claims)	1,117.4	1,206.0	1,247.9	1,323.1	1,110.7	1,323.1	1,550.0
Net Size (Claims)	680.0	745.0	775.0	810.0	665.0	810.0	950.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	274.3	280.9	282.0	285.7	269.5	285.7	335.0
Liabilities to Private Nonbank Foreigners	67.7	69.8	72.1	74.7	65.9	74.7	86.0
Total Claims on Foreigners	324.8	347.3	365.0	382.1	324.0	382.1	440.0
Claims on Foreign Public Borrowers	40.9	41.5	46.1	48.6	42.0	48.6	54.0
Claims on Foreign Private Nonbank Borrowers	118.1	129.4	133.1	138.6	117.7	138.6	165.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.